TRIAD
INVESTMENT MANAGEMENT

2nd Quarter 2009 Client Letter

"Not everything that can be counted counts, and not everything that counts can be counted."
- Albert Einstein

Einstein's quote provides a clue into how Triad manages investment portfolios. It starts with the numbers. Like most investment managers, we analyze financial statements and other publicly-available information. This establishes a foundation for comparing investments using similar metrics. Accounting attempts to present a picture of financial truth, but the reality is that accounting cannot capture all of the important economic considerations and factors that lead to long-term investment success. The financial statements are only a starting point, and an approximation of economic reality. Of course, even these numbers can and have been abused by dishonest, greedy people looking to benefit financially. But, assuming the financial statements are not fraudulent, when we do the "counting", I'm mindful that simple analysis of "the numbers" isn't enough. Why?

In a word, cash. Two companies can have similar "earnings" but one might produce more cash per dollar of earnings than the other. It all depends on the business characteristics and ability to turn revenue into cash. Some businesses produce more cash than needed to run the operations, and some businesses are continually starving for cash. Triad prefers the excess cash generators. For a fortunate but small percentage of companies, earnings are largely distributable cash. But the vast majority of companies don't create accounting earnings that represent cash available to pay out to shareholders. Most companies must reinvest the "earnings" into plant and equipment, research and development, accounts receivables, inventory, etc. Companies that don't need to reinvest as much into the business have excess cash that can be used to pay dividends, repay debt, make acquisitions or take other shareholder-friendly actions. So, how do I find companies that produce excess cash?

"Include Me Out."
- Samuel Goldwyn, American film producer, one of his many famous quotes

First, like Sam, I find myself saying "Include Me Out" when considering many investment opportunities. I have a long list of investments that I hope to never make. Why? Usually, it's because of the quality of the business. Certain industries and businesses have stronger "competitive moats" protecting them from competitors. Others don't. It's that simple, and great management can't fix a really bad business. Moat businesses often are in the enviable position of creating large amounts of cash, due to the protected business position and ability to maintain prices and profitability. Here's a sampling of industries that I generally avoid:

Airlines, Apparel Manufacturers, Auto Manufacturers, Food Processors/Wholesalers, Grocery Stores, Retailers, Steel, Telecommunications, Trucking

What do these groups have in common? An inability of most companies in these industries to establish a moat that can ward off competitors. Airlines are a good example. Most people don't much care which airline they fly. United Airlines, American Airlines, Delta or Southwest? Just give me the lowest fare, please. Hold the nuts. Get me from point A to B as quickly and safely as possible, and for the lowest fare. I'm exaggerating a bit, but you get the idea. For these competitors, it's hard to earn significant profits, as they are forced to keep prices in line with competitors. Not to mention recessions and reductions in passengers, gyrating fuel prices, labor unrest, and large capital outlays for the planes. Speaking of the lack of profits in the industry since the Wright Brothers, Warren Buffett commented in the 2007 Berkshire Hathaway annual report that had a farsighted capitalist been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down. Sam Goldwyn said it best- ***"Include Me Out"***. Don't expect to see an airline company in the portfolio any time soon. I've been in the investment business for almost 25 years and have yet to buy one airline share.

So, it would seem logical that common stock success is dependent on business success. But, there's one more element to investment success. The human element. Since a business is a social enterprise the people running the show are critical for long-term success. I examine what management writes and says to shareholders. I also look at objective measures such as management stock ownership and historical track record, but it all comes down to assessing a company's culture, and each is different. It's subjective and hard to quantify, but culture is important, especially in difficult times.

Finally, just because we've found a successful business with a strong moat and great management doesn't guarantee investment success. For a business to be a successful common stock investment requires attention to the price paid. I spend lots of time analyzing companies that we never invest in. Often it's because the business quality doesn't measure up, but just as often it's simply a matter of the stock not at attractive valuation levels. I may monitor a company for years waiting for the right purchase price. Price matters, and it's one of the important factors that we consider in buy and sell decisions.

What does all of this mean for the immediate investment outlook? One person's opinion:

"I think it's almost certain over a ten-year period that equities will do better than fixed-dollar investments. So, if people are keeping their money in cash and getting virtually nothing for it they may feel comfortable, but it will be very expensive for them over time."

- Warren Buffett quoted on CNBC June 24, 2009

Who better than the Oracle of Omaha to opine on the direction of stock prices over the next ten years? Of course, Buffett isn't attempting to predict the stock market's direction, but is making the case that on a **relative** basis the odds favor common stocks to provide higher returns than bonds and cash based on current valuations. It's partly due to the 40% stock market decline of the past two years, and partly due to the very low yields available on high-quality bonds and cash (roughly 1%-5%). For what it's worth, I agree with the Oracle.

I look forward to reporting our progress next quarter.

Sincerely,

John Heldman, CFA